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Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549
By E-mail: rule-comments@sec.gov

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Dear Sirs and Madams,

This letter comments on one aspect of the February 14, 2008 progress report of the Commission's Advisory Committee on Improvements to Financial Reporting (the "Report"). It encourages parts of the Report recommending that accounting standards be formed according to the *objectives* they are to achieve. It discourages use of language in the Report recommending that accounting standards be *principles-based*. The former recommendation, to let *objectives determine form*, is the one that the Commission endorsed in its 2003 study required by the Sarbanes-Oxley Act of 2002.[1] To recommend that standards be *principles-based* would be to put *form ahead of objectives*.

The Report veers between these recommendations, sometimes (1) recommending having *objectives determine form*, (2) putting *form ahead of objectives* and (3) treating them as if they are the *same thing*. The Report could be improved if it clarified that the form that standards take should be determined by the objectives that they are to achieve and that phrases describing form, such as principles-based, obscure that recommendation.

1. *Encouragement: Objectives Determine Form*. In the middle of the Report, discussion reflects the importance of defining objectives first and determining what form to use second. At page 50, the Report states: "Rather than engaging in a debate over terms such as 'principles-based,' 'objectives-oriented,' or 'rules-based,' we prefer to think of the design of accounting standards in terms of the *characteristics* they should possess (emphasis added)." The second half of that statement seems correct and I would add that the characteristics that standards should possess may differ with context. Sometimes desired characteristics will lead to the formulation of principles, sometimes to rules, sometimes to hybrids, sometimes to factor tests, and sometimes to other modes of expression. These realities seem acknowledged by, and consistent with, the conclusion in this part of the Report (at page 51): "we are considering supporting the increased use of

[1] Commission, Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the US Financial Reporting System of a Principles-Based Accounting System (2003).

objectives-oriented standards." That is a practical notion in accord with the Commission's 2003 study.[2] It has nothing to do with what form standards take.

2. *Discouragement: Form Ahead of Objectives*. In contrast, other parts of the Report seem to favor *principles-based* standards, without regard to objectives. The Report's Executive Overview twice states (at pages 4 and 5) its recommendation that accounting standard setters should use "more principles and fewer detailed rules." True, the Commission's 2003 study signaled a modest preference for principles than rules but only when doing so is possible given objectives. It is a mistake to prefer principles to rules for the sake of preferring principles to rules. The issue is what objectives a standard setter is trying to achieve. Objectives are about *substance*; to write standards using words that typify principles or words that typify rules (or other mode of expression) is about *form*.

A possible reason to prefer the form of principles to the form of rules (or other mode of expression) is the commonly heard view that rules invite abuse and that principles prevent it. The Report says (at page 62) that principles may be better for investors because they do not present manipulation risk, that rules can, to follow accounting standards while obscuring economic substance. But the Report also acknowledges, if implicitly, the limitations of this commonly heard assertion. It introduces the assertion with the phrase "*If properly implemented*." That is the fighting issue: *proper implementation* of any form of provision (rule, principle, hybrid, factor test) will do the trick. The choice of form to achieve an objective must include consideration of the probability that it will be properly implemented.[3]

Beyond requiring a good defense of any abstract preference favoring principles over rules (or a preference favoring any form over any other form), analysis would require basic additional elements. These include exploring what a principle is and what a rule is and how to describe a standard that contains both a principle and a rule.[4] Analysis would also have to acknowledge that standards can assume totally different forms other than rule or principle, including factor tests and innumerable hybrids. Analysis must ask

[2] A sub-committee advised the Committee as follows: "the principles vs. rules dichotomy is a specious debate and certain circumstances require more guidance than others." SEC Advisory Committee on Improvements to Financial Reporting, Subcommittee I: Substantive Complexity, Report for Discussion at November 2, 2007, Full Committee Meeting, at p. 9, http://www.sec.gov/about/offices/oca/acifr/acifr-sc1-report.pdf. It could be helpful for the Report to reflect the wisdom of this statement more forcibly.

[3] Many issues in addition to manipulation risk contribute to defining a standard's objective. Examples include conservatism, consistency, comparability, certainty, contextual flexibility, relevance and reliability.

[4] The importance of this element can be seen by observing that this part of the Report recommends "more principles and fewer *detailed* rules (emphasis added)." The adjective *detailed* to modify rules suggests there is nothing inherently obnoxious about rules but about *detailed* rules. This is a thicket, of course, for many rules are not detailed at all (the elementary example is a 55 mph speed limit) while many principles are notoriously detailed (the anti-fraud principles of the federal securities laws are a familiar example).